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PACIFIC TELESIS
Group-Washington

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December 11, 1995

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1 Price Cap Performance Review for Local Exchange Carriers. CC Docket No. 93-124 Treatment of Operator Services Under Price Cap Regulation. CC Docket No. 93-197 Revisions to Price Cap Rules for AT&T.*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and nine copies of their *"Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosures

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List ABCDE

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: December 11, 1995

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Summary

The Commission's proposals are a mixed bag. They combine genuine first steps toward pricing reform (such as volume and term discounts, and a reduction in the number of service bands) with a complex program of graduated price controls that, to a disturbing degree, cannot be squared with price cap principles or economic efficiency. The proposals in the *Second Notice* appear to be a classic example of the "mixed system" of competition and regulation that Prof. Alfred Kahn has called "the worst of both possible worlds."[1]

As the Commission considers what is certain to be a complex and voluminous record, we urge it to act in accordance with the following principles.

Simplicity. Some of the Commission's proposals would increase by orders of magnitude the complexity of regulation. The Commission proposes overlapping systems of regulation that might subject a carrier to price cap, streamlined, and nondominant treatment, at the same time, in the same geographic area, with respect to some of the same customers. (The Commission even considers having *two* different price cap systems, one in more competitive areas, one in less, in addition to streamlined and nondominant systems.)

The Commission offers few signposts to those who would embark on this journey. The Commission correctly emphasizes supply and demand elasticity as the best indicia of market power. But having the right economic theory is not enough to make the process work. For us to achieve streamlined regulation alone, the Commission would make

1 Alfred E. Kahn, *The Economics of Regulation* (Cambridge, Mass., 1988), p. xxxv.

us prove the competitiveness of *every* service in *every* area. We suspect that it would be just as burdensome for the Commission to adjudicate hundreds of these three-dimensional competitive showings, litigated and decided on nothing more specific than lofty principles, as it would be for us to present them.

Growing competition demands that regulation be simpler, not more complex. We propose a consolidation of price cap baskets and bands. Instead of the Commission's "streamlined" mode of regulation, we propose identifying competitive areas, based on objective and easily verified criteria, where we could offer access services under nondiscriminatory, generally available contracts, subject to Commission oversight but not price regulation. A similar system has operated successfully in California for years.

Efficiency. The Commission must not cling to artificial distinctions and price structures that have outlived their usefulness. Twelve years ago, for example, when the access charge structure was adopted, there may have been a difference between switched and special access. (Twelve years ago, state-of-the-art PC's had 64K of RAM, and the only fiber we had was one experimental ring being constructed for the 1984 Olympics.) Today, though the Commission knows that switched and special access are "substitute" facilities (see paragraph 24 of the Notice), it seems unwilling to abandon the increasingly legalistic distinction between them.

The Commission even proposes to use the service categories *within* the price caps baskets as the building blocks of streamlined regulation -- as "relevant markets." These service categories were even more artificially determined than the baskets. They were designed to moderate price changes and protect our competitors, not define economically relevant markets.[2]

Our proposal for contract-based regulation in competitive areas properly recognizes that switched and special access are substitutable. In their Report filed with these Comments, Prof. Kahn and Dr. Tardiff testify to the cross-elasticity between access services in competitive areas.

Consistency. Regulation must be relaxed in a way that is consistent with the Commission's policies. It has long been recognized that regulation should provide us with a reasonable opportunity to recover our costs.[3] Five years ago, we began price cap regulation with a price structure dictated by the Commission that assumed the absence of competition. Consistent with these principles, and having encouraged competition, the Commission has recognized that when price reductions to meet competition are necessary, a certain degree of pricing flexibility -- including upward pricing flexibility in "higher cost" markets -- is both necessary and desirable.[4]

In contrast with its deregulation of AT&T, the Commission's plan to deregulate us is difficult to square with these policies and principles. For example, as "relevant markets" (as the Commission defines them) are removed from price caps, we will have *less* flexibility to change price capped rates than we have today, and our total revenues

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[2] See *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, para. 223 (1990).

[3] See, for example, *West Ohio Gas Co. v. Public Utils. Comm'n,* 294 U.S. 63, 74 (1935); *Mississippi River Fuel Corp. v. FPC,* 163 F.2d 433, 437 (D.C. Cir. 1947).

[4] See *In the Matter of Expanded Interconnection with Local Telephone Companies,* 7 FCC Rcd 7369, para. 184 (1992).

will be reduced -- over and above whatever productivity (X Factor) reductions the Commission mandates in this docket. The Commission does not try to reconcile this reduction in pricing flexibility and reduction in total prices with its decisions on price caps, expanded interconnection, or any other decisions. It cannot be reconciled.

Our proposal for contract-based pricing in competitive areas would be more consistent with the Commission's policies than the Commission's own streamlining proposal. Our price cap rates would enjoy the same modest degree of pricing flexibility that the Commission's rules afford them today -- no more and no less.

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COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell (the "Pacific Companies") hereby respectfully comment on the Commission's *Second Further Notice of Proposed Rulemaking* (the "*Second Notice*") in the above-captioned proceeding.[1]

I. Introduction

In the *Second Notice* the Commission maps out an ambitious program to combine competition and price regulation. The "first gradation" of the tentative plan anticipates a slightly reformed version of price cap regulation. The second would be a hybrid animal, "streamlined" regulation, for services subject to "substantial competition." The third would be "nondominant" regulation, which approaches unregulated competition. While the second and third gradations

[1] *Price Cap Performance Review of Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, Revision of Price Cap Rules for AT&T,* CC Docket Nos. 94-1, 93-124, 93-197, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393 (released September 20, 1995).

are said to have been inspired by the recent regulatory history of AT&T and its competitors, the differences outweigh the similarities.

First, the new plan is considerably more complicated than anything suffered by interexchange carriers. In the past, streamlined regulation was applied to diverse groups of services wherever they were offered, and *carriers*, not services, were declared to be nondominant. The *Second Notice* departs from precedent by proposing overlapping systems of regulation: a carrier might be subject to price cap, streamlined, and nondominant regulation -- at the same time, in the same geographic area, in many cases dealing with the same customers. A service might be price capped in one area, streamlined in another, "nondominant" in yet a third -- and subject to some degree of competition in all three.

Second, while the Commission has recognized on at least three important occasions -- when it adopted price cap regulation;[2] when it ordered expanded interconnection;[3] and when it deregulated AT&T -- that moving prices toward economic costs may require raising prices as well as lowering them, the program for LECs in the *Second Notice* seems explicitly designed to preclude this. The cause is simple arithmetic. When competitive markets are removed from price caps as the Commission proposes, price reductions in those markets would

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[2] See *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order"): "a system of limited pricing flexibility .... is more desirable to permit LECs to migrate their rates toward a set of prices that enhances efficiency" (para. 35); "our goal is to permit incremental changes in prices that will assist LECs in achieving the efficiency objectives lying at the heart of this proceeding" (para. 198); "we elect ... the 5 percent boundaries of the 'no suspension' zone based on our judgment that LECs require some ability to change prices due to changing market circumstances" (para. 204).

[3] See *Expanded Interconnection with Local Telephone Company Facilities*, 7 FCC Rcd 7369, para. 184 (1992).

not "count" toward increases in price capped rates in the same baskets and bands, as they do now for us, and as they were allowed to do for AT&T.[4]

The *Second Notice* never explains these inconsistencies with the Commission's regulation of AT&T and its prior statements about the need for (upward as well as downward) pricing flexibility for the LECs as markets become more competitive. The Commission said when it declared AT&T to be nondominant that "simply because . . . rates may rise in a competitive market does not mean that they will be unreasonable."[5] As AT&T stated in its 1993 Annual Report:

> In the latter half of 1993 we raised some of our prices and fees -- about $500 million on an annual basis. These increases were primarily for services where customer demand is not very sensitive to price.

Most of these price increases were in higher toll rates. As the Commission has acknowledged, they were made possible by discounts and promotions.[6]

The consequences if the Commission's program fails would be enormous. The

[4] Of course, under the current price cap system, any "upward" pricing flexibility is applied *after* reductions for productivity, sharing, exogenous events, etc. In nominal terms upward pricing flexibility may not result in higher prices at all.

[5] *Motion of AT&T Corp to be Reclassified as a Non-Dominant Carrier*, Order, FCC 95-427 (released October 23, 1995), n. 221 ("AT&T Non-Dominant Order").

[6] *Id.,* paras. 81-84.

deregulation of AT&T has been a partial success,[7] but the program the Commission tentatively proposes for LECs is far more complex and constrained -- and therefore, we submit, more trouble-prone -- than its program for AT&T was. The implicit "exit fee" that we would pay for responding to competition is all the more disturbing because promoting competition has been the Commission's deliberate aim. We do not object to competition *per se,* but to the degree that such disjointed policies threaten our ability to recover our costs, as we believe they do, it raises serious legal issues.[8]

The difficulty of successfully mixing competition and regulation cannot be overstated. In 1970, in his classic The Economics of Regulation, Prof. Alfred Kahn said optimistically that the "proper object of search in each instance is the *best possible mixture*" of regulation and market forces. By 1988, with the benefit of greater experience, his outlook had changed. "Recent experience clearly suggests ... that the mixed system [of competition and direct regulation] may be the *worst of both possible worlds.*"[9]

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[7] A great success for AT&T's shareholders: its cumulative earnings growth since divestiture has far outstripped ours. AT&T now has $80 billion in annual revenues, $8 billion in annual cash flow. It is simply inconceivable that anyone but AT&T could have spent $21.5 billion (and assumed debt) to acquire McCaw Cellular, then proceeded to spend $1.7 billion more for PCS licenses, and commit to spend $4 billion more to build these PCS networks and link them to McCaw's -- all after its costly acquisition of NCR. See John J. Keller, "AT&T Eagerly Plots A Strategy To Gobble Local Phone Business," Wall St. J., Aug. 21, 1995, at A1 ("AT&T Eagerly Plots").

But long distance competition has been a much more limited success for consumers. One quick way to judge the competitiveness of the long distance toll business is to compare its pricing characteristics with those of the air transportation business. Today, about ninety percent of all airline tickets are discounted, and the average discount is about two-thirds off the full fare. In contrast, according to AT&T's own figures, 63% of its customers are not on any discount plan. AT&T's principal discount plan, "True Reach", requires $10 of calls a month. Bills of up to $25 receive a 10% discount. To reach a 30% discount, a customer must spend $70 a month.

[8] See *MCI Communications v. Amer. Tel. & Tel. Co.,* 708 F.2d 1081 (7th Cir. 1983), *cert. denied* 104 S.Ct. 234.

[9] Alfred E. Kahn, *The Economics of Regulation* (Cambridge, Mass., 1988), p. xxxv (emphases added).

The program in the *Second Notice* is commendable for recognizing that we need immediate relief -- such as volume discounting, contract-based pricing, new service reform, and price cap simplification -- not only to respond to competition, but to correct obvious inefficiencies in our pricing structure. It is also commendable for moving toward an economically sound definition of market power, based on supply and demand elasticities. But it is still characterized by some of the "most troublesome" restraints (as Kahn described them) of the "mixed system."[10] Till the day when our entire enterprise would gain nondominant status, we would continue to be subject to price and output controls, tariffing requirements, and obligations to serve that our competitors do not have. To the degree that price reductions in competitive areas could not be offset by increases in higher-cost areas, our ability to rebalance prices would actually be less than today. Geographic averaging combined with price cap regulation would continue to force down some prices that are already below competitive levels. Competitive entry in those areas would continue to be thwarted.

With these Comments, we submit a report prepared by Prof. Alfred E. Kahn and Dr. Timothy J. Tardiff analyzing both the Commission's and Pacific's proposals.

II. Reforming Price Cap Regulation

Growing competition demands that price cap regulation be simplified, not complicated. Our answers to the Commission's questions (in italics) and our proposal follows.

Issue 1a: *Should we relax the regulatory requirements relating to new services for some or all new services? Will there be any anti-competitive or other negative effects as a result of such modifications to the plan? If a relaxed treatment is appropriate for only certain new services, how should we distinguish between the services eligible for the simplified treatment and those which are not? What are some examples of the services that would fall into each category? How would this distinction be administered? What cost showings, notice, and other regulatory requirements are necessary with respect to the various types of new services to provide the*

[10] See *id.*

appropriate level of regulatory oversight without hindering the efficient introduction of new services?

Issue 1b: *Should we modify the definition of new services to exclude APPs or otherwise?*

Issue 1c: *Should we modify the definition of restructured services? What, if any, changes should be made with respect to the treatment of restructured services?*

The Commission's current regulation of new service offerings is both economically and legally unsound.

It is economically unsound because, as economists have long recognized, new services make a positive contribution to consumer welfare by adding to consumers' choices. This is true regardless of their price. Indeed the opportunity to charge a premium for new services or technologies is what gives private enterprises an incentive to develop and offer new services.

The Commission's current regulation of new services is also legally unsound. The Communications Act requires the Commission to encourage the introduction of new services and technologies:

> It shall be the policy of the United States to encourage the provision of new technologies and services to the public. Any person or party (other than the Commission) who opposes a new technology or service proposed to be permitted under this Act shall have the burden to demonstrate that such proposal is inconsistent with the public interest.[11]

Contrary to its mandate, the Commission effectively discourages the introduction of new services by imposing both price and output controls on them. We know the Commission does not intend to discourage them, but unavoidably, that is what price and output controls do. The Commission has taken the position that we may not offer new services (except for special access) until the

[11] 47 U.S.C. 157(a).

Commission's rules are amended to describe them, or unless the carrier demonstrates that a waiver of the rules is justified. Even when it has permitted new services, the Commission has carefully regulated their price, rarely allowing a premium to be charged.

The *Second Notice* acknowledges the need to simplify the new service approval process. The Commission proposes to revise the definition of new services to exclude APPs -- "services that permit customers to 'self-select' an optional discounted rate for a service which continues to be offered to customers" (para. 52). We support this change. As the Commission correctly reasons, "LEC customers would be protected because the original offering was subject to normal regulatory review and customers still have that service choice available to them" (*id.*). But we would like to point out that this is true of *all* new service offerings. Customers are *ipso facto* better off if a "new option" is available than if it is not.

Though it mandates the encouragement of new services and technologies, the Act does not allude to the Commission's concern about "ensur[ing] that other providers can effectively compete with the LEC" (*id.*).[12] That no other providers offer a new service only proves that the new service offering is in the public interest -- at whatever premium would encourage further innovation and a greater number of providers, consistent with just and reasonable rates. The presence of competing providers, on the other hand, in almost every case destroys any economic rationale for price regulation of the new service. Thus when the Commission ponders whether "the absence of a close substitute [for a new service] to which a LEC customer could turn warrants more careful regulatory review of the new service" (para. 47), it threatens to get things backwards. The absence of a close substitute for a new service is

[12] See *FCC v. RCA Communications, Inc.*, 346 U.S. 86, 94-5 (1953); *Hawaiian Tel. Co. v. FCC*, 498 F.2d 771, 776 (D.C. Cir. 1974).

reason to presume that it is in the public interest, not a reason to delay or discourage it with "careful regulatory review."

We expect most new offerings to be the result of incremental improvements in network functionality. Because we do not manufacture telecommunications equipment, we rarely have access to technology or know-how that is not already on the market. SONET, fast packet switching services (frame relay and SMDS), and ATM switching, for example, are based on new switch functionalities developed by switch manufacturers (*e.g.*, AT&T, Newbridge, and Stratacom). For this reason, any advantage we might have over our competitors is short-lived. By the time a new service is allowed and a tariff has taken effect, we are rarely the first or only provider; usually, a multitude of service providers offer fully competitive products. These competitors' products usually compete with our existing product line, so lengthy reviews of new service offerings hurt already-tariffed services.

We agree that new services that are "essential to a LEC's competitors" (para. 47) present a special case and may be treated differently from other services. But such services are likely to be rare. The Commission's characterization of "essential services" is incorrect. The Commission suggests these are services which "*facilitate* ... competitive entry," for example by enabling the LECs' "competitors to offer transmission segments that can substitute for the previously bundled segments offered by the LECs." (*Id;* emphasis added.)

This is not the definition of essential facilities found in the case law. A facility is not "essential" if its denial merely handicaps potential competitors.[13] "As the word 'essential' indicates, a plaintiff must show more than inconvenience, or even some economic loss; he must show that an alternative to the facility is not feasible.... A facility that is controlled by a single

[13] *Alaska Airlines, Inc. v. United Airlines, Inc.*, 948 F.2d 536, 543 (9th Cir. 1991) (citing *Otter Tail Power Co. v. United States,* 410 U.S. 366 (1973)).

firm will be considered 'essential' only if control of the facility carries with it the power to *eliminate* competition in the downstream market."[14]

A bottleneck or "essential facility" is well-understood by courts and economists to have three elements. It must be incapable of being duplicated; it must be necessary, not merely desirable, for competitors to have access to the facility to compete with its owner; and its denial must impede competition in the downstream market.[15] This test from the antitrust case law has a strong economic rationale behind it. No valid economic purpose is served by requiring one provider to make available a facility to its competitors merely because the facility confers a competitive advantage (even a unique advantage) on its owner. Instead, it may retard competition by depriving the most efficient provider of one source of its efficiency, while rewarding the relative inefficiency of its competitors and discouraging investment in alternative facilities. The purpose of economic regulation is to promote low prices for consumers, not "facilitate" competitive entry. As Justice Stephen Breyer wrote for a panel of the First Circuit:

> a practice isn't "anticompetitive" simply because it harms competitors. After all, almost all business activity, desirable and undesirable alike, seeks to advance a firm's fortunes at the expense of its competitors. Rather, a practice is "anticompetitive" only if it harms the competitive process. It harms that process when it obstructs the achievement of competition's basic goals--lower prices, better products, and more efficient production methods.[16]

In the rare cases where the Commission requires LECs to provide an essential service or facility to their competitors, the only necessary safeguard is that the price of the

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[14] *Id.* at 544 (emphasis in original) (quoting *Twin Laboratories, Inc. v. Weider Health & Fitness*, 900 F.2d 566 (2d Cir. 1990)).
[15] See *United States v. Terminal R.R. Ass'n,* 224 U.S. 383 (1912).
[16] *Town of Concord, Mass. v. Boston Edison Co.*, 915 F.2d 17, 21 (1st Cir. 1990) (internal citations omitted).

service should not exceed the direct costs *plus* the contribution to fixed costs and overheads that is foregone by wholesaling the service to competitors.

We support the Commission's proposal to incorporate APPs into price caps after no more than 90 days, as was the case with AT&T's APPs. All other new services should be excluded from price caps and offered, at the carrier's option, under either a general or customer-specific tariff. Consistent with the statutory mandate to encourage the introduction of new technologies and services, they should be presumed lawful and be effective a short time after filing (such as 7 days) -- no longer than is necessary for petitioners to evaluate and contest them. No waiver of the rules should be required, and the burden of proving that new services are not in the public interest should be on challengers -- where the statute puts it -- not on new service providers.

Issue 2a: *Should we allow LECs to file APPs in addition to the volume and term discounts currently permitted? Under what terms and conditions? How should APPs be defined? Would the introduction of APPs cause any anti-competitive effects? If we permit LECs to offer APPs, what notice, cost support, and other requirements should be applied to those tariff filings? Should the rules be different depending on the particular LEC service basket or services involved and, if so, how? How and when should APPs be integrated into the price cap plan?*

Issue 2b: *If we do not generally permit LECs to introduce APPs, should we nevertheless permit volume and term discounts for switched access services other than those currently permitted? If so, should we condition such offerings on a showing of competitive presence similar to the conditions adopted in the Switched Transport Expanded Interconnection Order or on the other measures of competition discussed in this Second Further Notice in the geographic areas where such competition exists?*

Issue 3: *Under what conditions, if any, should we permit price cap carriers to establish ICB rates? What showing would enable us to determine that the carrier cannot reasonably be expected to establish generally available averaged rates at the time the common carrier service is introduced? How long should we permit those rates to remain in effect before we require generally available averaged rates? What cost support requirements should apply when the carrier files ICB tariffs, and when the LEC files tariffs establishing generally available averaged rates?*

Promotional offerings, volume and term discounts, and individual case basis pricing foster efficiency and promote competition. They recognize the sometimes vastly different costs of supplying the same service to different customers. Volume discounts not only exist in every competitive market, but as the Commission has recognized ever since it approved volume discounts in the early 1980s, are fully justified even when competition is nascent.[17] They are an essential means to drive rates closer to economic costs and keep customers on our network.

As the Commission has recognized both with respect to APPs (para. 52), and volume discounts generally,[18] discounts and promotions are not unreasonably discriminatory. The discounts or promotions are available to all customers who qualify for them, and the original offerings remain available as well. They do not raise any potential for competitive harm as long as their prices exceed direct costs. They deserve the same streamlined review as new services.

We do not agree that "when a carrier has more than two customers for a common carrier service, or has provided the service for six months or more, it has or should have sufficient experience with the service to develop averaged rates" (para. 65). The Commission should be moving toward allowing customer-specific rates, not averaging. In his contribution to the *Handbook of Industrial Organization,* for example, Prof. Hal Varian begins by quoting the Boston Consulting Group's advice to competitive firms: *"avoid average pricing":*

> Pricing to specific customer groups should reflect the true competitive value of what is being provided. When this is achieved, no money is left on the table unnecessarily on the one hand, while no opportunities are opened for competitors through inadvertent overpricing on the other.[19]

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[17] See *Private Line Rate Structure and Volume Discount Practices,* Report and Order, CC Docket No. 79-246, 97 F.C.C. 2d 923 (1984).
[18] *Id.*
[19] R. Schmalensee and R.D. Willig, *Handbook of Industrial Organization,* v. 1, p. 598 (1989).

As long as they exceed direct costs, such customer-specific pricing poses no threat to competition. The Commission has lagged behind most state regulatory commissions in recognizing the potential benefits of contract pricing.

In California, we have been able to provide intrastate access under (filed) contracts rather than tariffs since 1987. Partially competitive and fully competitive services may be offered on terms and conditions different from those in the general tariff for the service. Usually, the permissible price floor for each rate in such contracts is LRIC. Contracts that price above a statewide average cost floor and present no novel issues go into effect within fourteen days after being filed with the CPUC, unless the CPUC's Commission Advisory and Compliance Division (CACD) rejects them. Alternatively, contract prices may be based on a customer-specific cost, with affirmative approval by the CPUC.

The contracts filed with the CPUC must disclose the terms of the agreement (prices, service descriptions, volume limitations, and term). The customer's name may be kept confidential. Any customer proprietary or otherwise commercially sensitive information may be submitted under confidential seal. Pacific Bell must also provide (under seal) the CPUC's CACD with network diagrams of the service, a list of the services being provided under the contract, and the price floor and ceiling applicable to each service, among other things. Intervening parties may protest any contract that Pacific Bell files. However, the CPUC monitors protests closely to assure that protesters are not merely trying to gain a competitive advantage by delaying the effective date of a contract. The CPUC has made its intent clear by disregarding and summarily dismissing any protest that appears to have been filed other than to inform the CPUC of a legitimate issue of public concern.[20]

Pacific Bell and the CPUC have spent eight years developing these guidelines. The process has worked well, affords the protections the marketplace needs, and has stimulated competition in California. The CPUC guidelines address each of the concerns this Commission articulates in its question (above). The guidelines assure that contracts are not priced anticompetitively, while affording Pacific Bell a chance to meet competition. The CPUC implemented contracting flexibility for carriers under its jurisdiction because it:

> has long recognized that circumstances may justify a utility's providing service to individual customers at other than the tariff rate. Customers with unusual service characteristics, service options, or bargaining power will frequently negotiate with the utility to obtain a better rate or a more customized service than is offered under tariff. [For this reason] we have adopted procedures to streamline approval of contracts deviating from the tariff when the contracts were responses to emerging competition for what had historically been monopoly services.[21]

The CPUC has reasoned that the entire marketplace and consumers are better off if LECs have contracting flexibility in competitive areas. Since the price floors ensure that the contract price contributes toward the LEC's fixed costs of operating its network, the LEC's other customers also benefit since the LEC retains business it would otherwise have lost.[22]

Unfortunately, a substantial number of our services must be offered from Federal tariffs under Federal rules that are not nearly as progressive as the CPUC's. Our competitors' ability to offer one-stop shopping for interstate services gives them a significant competitive advantage. Between 1993 and 1995, for example, customers using our competitors' transport

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[20] *In re Alternative Regulatory Frameworks for Local Exchange Carriers,* 1994 Cal. PUC LEXIS 681 (citations omitted).
[21] *Id.*
[22] *Id.*

services (which, due to the 10% "contamination" rule, are disproportionately interstate) more than doubled in San Francisco (to 37%) and increased by a third in Los Angeles (to 39%).[23]

Our own market research indicates that 66% of residential and 80% of business customers are likely to choose just one telecommunications provider if it offers a one-stop shopping package. Indeed, AT&T considers one-stop shopping to be so critical that it has made it the linchpin of its business strategy and restructured its business accordingly:

> AT&T Corp., girding for its push into local telephone services, has created a division of five regional entities to attack the Baby Bells in their home markets.
>
> The plan is contained in an internal memorandum circulated last week by AT&T Communication Services czar and future president Alex Mandl. While the memo never mentions the regional Bell companies directly, it clearly shows that AT&T intends to a full-scale attack on all seven of its Bell offspring simultaneously, using a regional management structure that shadows the Bell organizations....
>
> The reorganization is part of a 10-year strategic plan which the memo dubs "Target: Growth 2005 strategy." AT&T aims to offer consumers and businesses a new kind of communication service that would use a simplified pricing setup -- perhaps one flat rate, regardless of the type of call -- and bundle together local, long-distance and wireless services....
>
> The regionalized structure could enable local executives to tailor pricing and promotional packages to their particular audience. "I am convinced that this organizational model will greatly improve our ability to understand customer needs and to innovate and package services to meet them on an end-to-end basis," Mr. Mandl said in his Nov. 29 memo....
>
> The local assault will be one of the major focuses of the "new" AT&T that remains after its self-imposed, three-way split-up set for the end of next year.[24]

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[23] "Pacific Bell Second Quarter - 1993 High Capacity Services Market Share, San Francisco and Los Angeles, Quality Strategies, June 25, 1993; and "Pacific Bell Hicap Track Third Quarter, 1995," Quality Strategies, August 8, 1995.

[24] John J. Keller, "AT&T Targets Home Markets of Baby Bells," Wall St. J., December 5, 1995, pp. A3-4.

Doing business on the basis of customer-specific contracts cannot be a "reasonable" practice for our competitors to engage in, but not us. More than six years ago the Commission determined that integrated service packages, if generally available to all customers, were not unreasonably discriminatory. The Commission reasoned:

> The ... differences between service under integrated packages and service under disaggregated tariffs have particular relevance to the underlying economics of integrated service packages. Modern economic theory teaches that there are powerful reasons for differences in the cost of production for an otherwise similar commodity depending on the rate at which it is produced. The cost of producing a commodity will be different depending upon the rate at which it is produced, its current cumulative production levels, and the total expected volume of output. It is often cheaper to produce a large quantity at a continuous rate, than to produce smaller lots at varying rates.
>
> Modern economic analysis also teaches that the terms of contract are often of crucial importance to the organization of economic activity. The stability of contract terms is even more important when the service purchased is combined with complementary inputs to produce the service that is really desired by the user. The terms and stability of the basic service affect the buyer through their effect on the productivity of the complementary products as well as through their direct effects. In telecommunications, this latter factor is apt to be quite significant since common carrier telecommunications services are used with data processing equipment to produce integrated information management services.
>
> Integrated service packages combine these two economic characteristics. Package offerings, by combining a mutual commitment to a specified volume and level of service, offer both the possibility of cost reductions from providing the more stable set of outputs, as well as the additional value which the package offering may provide the customer.[25]

The courts have recognized another reason to encourage business under customer-specific rates rather than rate-averaged tariffs: the sharing of pricing information can facilitate price fixing,

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[25] *AT&T Communications Revisions to Tariff F.C.C. No. 12,* 4 FCC Rcd 4932, paras. 50-52 (1989).

because such tariffs inevitably "telegraph" price signals to competitors, not just customers. Requiring only the dominant carrier to file such tariffs is especially troublesome, as the Supreme Court has observed, because it is "the firm most likely to be a price leader."[26]

All of these observations about the benefits of customer-specific pricing in the interexchange market apply with equal force to the access market. Yet the Commission's access rules have not been allowed to catch up to them. Today the only interstate "package" we may offer customers is a collection of services they could order for themselves out of tariffs -- tariffed rates that may not reflect the network functions the customer needs, the economic costs of the combined services or any real cross-elasticities between them.

The justification that our competitors usually offer for this asymmetrical restriction on the LECs is that as "infants" they need the protection.[27] But as Prof. Kahn testified in this proceeding last year:

> Continuing regulatory restrictions on the LECs -- such as required approvals, cost justifications reporting requirements and restrictions on their prices -- bearing on them but not on their competitors, not only handicap them in competing but to this extent also deprive consumers of the full benefits of their possible competition, enabling rivals to obtain business by pricing at levels just below the prevailing regulatorily-prescribed rates. For example, it is surely anomalous, as Bell Atlantic points out, for it to be subject to these kinds of restrictions on its pricing of such very competitive offerings as high-capacity access services.
>
> Such handicaps are often justified, either explicitly or implicitly, on the ground that the entrants require some preferences in order to give them a fair opportunity to enter markets and so eventually to give the public the benefits of competition. Deliberate efforts to "jump start" competition in this way, whether by giving preferences to the entrants or handicapping

[26] *MCI Tel. Corp. v. American Tel. & Tel. Co.*, 129 L. Ed. 2d 182, 195 (1994).

[27] See for example *Southwestern Bell Tel. Co. Tariff F.C.C. No. 73,* Transmittal Nos. 2433 and 2449, CC Docket No. 95-140, FCC 95-476, Order Terminating Investigation (released November 29, 1995), para. 14 ("Petitioners ... claim that ... the Commission's policies ... [are meant to] 'ensure a marketplace where competitive access providers can gain a meaningful foothold prior to increased pricing flexibility for LECs'").

incumbents, constitute a form of infant industry or infant company protection.

While it is not possible to state, as a general proposition, that infant industry protections are unequivocally incorrect, most economists would question their wisdom in most circumstances. First, they inevitably impose immediate costs on consumers and the economy because, by placing restrictions on the freedom of incumbents to compete or higher costs on them than their rivals, they prevent business from being distributed among competitors on the basis of their relative costs. Second, while those costs are tangible and certain, the benefits are not: it is virtually impossible to determine in advance that a would-be competitor both requires and deserves some special preference -- that is to say, that the long-term benefits to consumers of the competition encouraged in this way, properly discounted for both their futurity and their uncertainty, exceed the costs. The lesson of history, instead, is that so long as companies are insulated from competition, they are, to that extent and for that reason, less likely ever to "grow up" and undertake to compete without such special protections. The system encourages them, instead, to devote their energies primarily to seeking (before both regulators and the courts) to perpetuate their preferential subsidies and protections. The history of U.S. telecommunications regulation amply confirms the importance and dangers of this kind of continual "rent-seeking." For all these reasons, it is preferable by far to leave determinations of the long-term prospects of new and uncertain ventures of this kind is indeed meritorious, the general presumption is that investors will be willing to supply the necessary capital.

This preference is particularly compelling as it relates to would-be competitors in telecommunications, where the principal aspiring entrants are obviously neither newcomers nor "infants." The most prominent ones are either themselves or affiliates of long-distance carriers like AT&T and MCI or cable companies or manufacturers of electronic equipment or of computers, like Motorola. Among the largest competitive access providers are MFS, a subsidiary of a large international construction firm, and Teleport, which is jointly owned by Cox Enterprises, TCI and Time Warner, among others; and, as I have already pointed out, some of the threatening direct competitors of local exchange companies are combinations of the country's largest multiple cable system operators and domestic or foreign telephone companies.[28]

The CPUC's policy of contract-based pricing works. This Commission should adopt contract-based pricing as well. As we explain in Part II (Streamlined Regulation), below,

[28] Affidavit of Prof. Alfred E. Kahn, CC Docket No. 94-1, June 28, 1994, at pp. 6-7.

it can easily be accommodated in existing regulation, and is more consistent with the Commission's policies than the streamlining program proposed in the *Second Notice*.

Issue 4a: *Should we eliminate the requirement for, or simplify the process of, obtaining a waiver of Part 69 for new switched access services and, if so, how? What standard should we use in determining whether to grant a petition proposing to establish new rate elements for a switched access service? Would there be any anti-competitive or other negative effects from modifying the current system?*

Issue 4b: *How should any new procedures with respect to Part 69 waivers be coordinated with the process for determining whether a new service is a Track 1 or Track 2 service as defined in the previous subsection herein if those concepts are adopted?*

Part 69 waivers should not be required for any new services. New services should not be delayed or discouraged by an adjudicative process in which the burden of proof is on the new service provider. The process should be speedy and self-executing. The current Part 69 waiver process is completely unnecessary for the Commission to consider whether new services should be offered. New services are in the public's interest *per se*. The reasonableness of their rates may already be considered under numerous sections of the Act, including Section 204 and Section 208.

With the cautions we expressed above (pp. 7-8), we support the Commission's proposal that only "services essential to a LEC's competitors" (para. 47) receive "Track 1" review. The essential facilities test developed in antitrust law would provide the "bright line" the Commission needs to make the Track 1/Track 2 distinction easy to administer. All other new services should be subject only to the tariff review process. New services should be presumed lawful and effective upon a short notice period.

Issue 5a: *Should we further expand or eliminate the lower service band index limits for all access services? Does there remain a danger of predatory pricing or other anti-competitive practices? Would this additional downward pricing flexibility harm any LEC customers? Would it harm competition?*